

THE OHIO STATE JOURNAL ON DISPUTE RESOLUTION

VOLUME 10

1994

NUMBER 1

Opening Offers and Out-of-Court Settlement: A Little Moderation May Not Go a Long Way

RUSSELL KOROBKIN*

CHRIS GUTHRIE**

I. A BARGAINING MODEL OF LITIGATION SETTLEMENT

When two litigants resolve a dispute through out-of-court settlement rather than trial, they realize joint gains of trade equal to the sum of the costs both parties would have incurred had they obtained a trial judgment minus the costs they incur reaching settlement.¹ This opportunity for mutual gain causes most civil lawsuits to settle out-of-court.² Yet, in spite of the

* Research Fellow, Stanford Center on Conflict and Negotiation (SCCN). B.A. 1989; J.D. 1994, Stanford.

** Research Fellow, Stanford Center on Conflict and Negotiation (SCCN). B.A. 1989; J.D. 1994, Stanford; M.Ed. 1991, Harvard.

The authors extend special thanks to Robert Mnookin, Janet Cooper Alexander, Lee Ross, Robert Wilson, and seminar participants at Harvard Law School and the SCCN for helpful comments and criticisms. Generous funding from the SCCN is gratefully acknowledged.

¹ For clear descriptions of this standard economic account of the value of settlement in civil litigation, see George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 4-6 (1984). See also Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 417-20 (1974). For a similar analysis in the context of criminal cases, see William M. Landes, *An Economic Analysis of the Courts*, 14 J. L. & ECON. 61, 66 (1971).

² The exact percentage of lawsuits that settle out of court varies by jurisdiction and type of lawsuit. One seminal study, now 20 years old, found that only 4.2% of claims filed against insurance companies ultimately reached trial. See H. LAURENCE ROSS, *SETTLED OUT OF COURT: THE SOCIAL PROCESS OF INSURANCE CLAIMS ADJUSTMENTS* 179 (1970). A 1980 study found 6.5% of suits in federal district courts reached a trial. DIRECTOR OF THE ADMINISTRATIVE OFFICE OF THE U.S. COURTS, *ANNUAL REPORT OF THE DIRECTOR*, A-28 (1980). A more recent study found that approximately 8% of civil suits filed in state and federal courts went to trial. David M. Trubek et al., *The Costs of Ordinary Litigation*, 31 UCLA L. REV. 72, 89 (1983).

opportunity for joint gain, negotiations fail in a significant number of lawsuits. One reason for this surprising result is that even when joint gains are substantial and obvious to the litigants, they still must agree on a method of dividing those gains of trade³ — a delicate and often perilous undertaking.

Robert Cooter, Stephen Marks, and Robert Mnookin propose a model of pretrial bargaining that presumes rational negotiators will attempt to strike a balance between appropriating all of the joint gains for themselves on one hand and ensuring that settlement is reached on the other.⁴ This strategic bargaining model predicts that if one litigant offers the other all of the surplus created by the settlement, agreement is nearly certain.⁵ However, as that litigant attempts to appropriate more and more of the surplus for himself, he runs an increased risk of a breakdown in negotiations and a subsequent trial.⁶ If he attempts to appropriate all of the surplus for himself, negotiation impasse and trial are particularly likely to follow.⁷

According to this model, a rational litigant selects the bargaining strategy that he believes will enable him to appropriate as much of the surplus as he can without pushing the other side to trial.⁸ The litigant's most important strategic choice is the relative "hardness" of the strategy he will pursue.⁹ For Cooter, Marks, and Mnookin, one strategy is harder than another when all of the settlement offers made by a litigant following that

³ See Robert Cooter et al., *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225, 225 (1982).

⁴ *Id.* at 227-29. We have chosen to use the Cooter, Marks, and Mnookin model as the point of departure for our discussion because it is specifically concerned with the effect of settlement offers on litigation negotiations. *Id.* at 228-29. A broad range of strategic bargaining models, generally published in economics journals, offer a variety of predictions regarding the effects of opening offers on negotiations, depending on the underlying assumptions of those models. See, e.g., In-Koo Cho, *Uncertainty and Delay in Bargaining*, 57 REV. ECON. STUD. 575 (1990); Peter C. Cramton, *Bargaining with Incomplete Information: An Infinite-Horizon Model with Two-Sided Uncertainty*, 51 REV. ECON. STUD. 579 (1984).

⁵ Cooter et al., *supra* note 3, at 228.

⁶ See *id.* at 231 ("If a player adopts a hard strategy, then he receives a larger share of the stakes in the event of settlement. But a harder strategy is less likely to result in settlement.")

⁷ See *id.* at 228.

⁸ See *id.* at 231 ("Thus, a player finds his optimal strategy trading off a larger share of stakes against a higher probability of trial.")

⁹ See *id.* ("Choosing the strategy of optimal hardness is almost identical mathematically with choosing the optimal final demand.")

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

strategy are as low as or lower than all of the offers made following the other strategy.¹⁰ A litigant adopting a harder strategy faces a greater risk of failed settlement discussions than a litigant adopting a softer strategy.¹¹ In return for this risk, the litigant can expect a larger division of the joint gains if he and his adversary reach settlement.¹²

The Cooter, Marks, and Mnookin model seeks to predict settlement or trial of a legal dispute based on the strategies employed by the litigants, without reference to the number of pretrial offers and counteroffers exchanged.¹³ Other research suggests that surprisingly few settlement offers are exchanged between parties during the course of most civil lawsuits.¹⁴ Herbert Kritzer, who examined settlement behavior in 1,423 cases from state and federal courts in five jurisdictions, found that “only fifteen percent of the lawyers reported that their cases involved as many as three exchanges,” while the highest percentage of responding lawyers reported only two offers or counteroffers.¹⁵ Because pretrial bargaining typically includes few exchanges, the opening settlement offer is perhaps the most important aspect of the bargaining strategy employed by a litigant, and it deserves special attention.

When deciding what opening offer strategy to pursue, a litigant may select a relatively soft position by making a “moderate” opening offer (one that is reasonably related to an outcome the parties might expect a court to impose)¹⁶ or a relatively hard position by making a more “extreme” opening offer (one that clearly favors the litigant making the offer).¹⁷ Most research on opening offers has focused on the effect they have on a litigant’s

¹⁰ Cooter et al., *supra* note 3, at 230.

¹¹ *Id.* at 231.

¹² *See id.*

¹³ *See id.* at 229–30.

¹⁴ *See* HERBERT M. KRITZER, LET’S MAKE A DEAL 36–41, 132 (1991).

¹⁵ *Id.* at 37.

¹⁶ At least one author has suggested that a “cooperative” negotiator should begin bargaining with an opening proposal that exceeds “the negotiator’s target point by a modest amount.” DONALD G. GIFFORD, LEGAL NEGOTIATION: THEORY AND APPLICATIONS 109 (1989).

¹⁷ The literature does not define the terms “moderate” and “extreme” with any precision. Generally speaking, a “moderate” opening offer is one that is relatively close to the settlement value, while an “extreme” opening offer is one that is much lower or higher than the settlement value. *Id.* Thus, if a defendant will settle for \$25,000, an opening offer of \$20,000 would be considered “moderate” and an opening offer of \$10,000 would be considered “extreme.”

success at obtaining a favorable settlement for himself.¹⁸ Both empirical¹⁹ and experimental²⁰ studies on this issue have concluded that a litigant is likely to achieve a more advantageous settlement if he opens negotiations with an extreme, rather than a moderate, settlement offer.²¹

Inferring from the prediction of the Cooter, Marks, and Mnookin bargaining model that "a harder strategy is less likely to result in settlement,"²² we predict that the distributional advantage gained by making an extreme opening offer comes at a price. Specifically, we hypothesize that the litigant who makes an extreme opening settlement offer is less likely to reach a settlement with his adversary than the litigant who opens with a moderate offer. The hard nature of an extreme opening offer carries with it

¹⁸ See, e.g., KRITZER, *supra* note 14, at 36-52; Jerome M. Chertkoff & Melinda Conley, *Opening Offer and Frequency of Concession as Bargaining Strategies*, 7 J. PERSONALITY & SOC. PSYCHOL. 181 (1967); Bernard J. Hinton et al., *The Influence of Reward Magnitude, Opening Bid and Concession Rate on Profit Earned in a Managerial Negotiation Game*, 19 BEHAVIORAL SCI. 197 (1974); S. S. Komorita & Arline R. Brenner, *Bargaining and Concession Making Under Bilateral Monopoly*, 9 J. PERSONALITY & SOC. PSYCHOL. 15 (1968); Robert M. Liebert et al., *The Effects of Information and Magnitude of Initial Offer on Interpersonal Negotiation*, 4 J. EXPERIMENTAL SOC. PSYCHOL. 431 (1968).

¹⁹ In his exhaustive study of 1,423 cases, Kritzer found that plaintiffs and defendants who made extreme initial offers obtained more favorable settlements for themselves than those who did not. He concluded that extreme opening offers "stand out as the strongest predictors of success for each of the two sides." KRITZER, *supra* note 14, at 54; see also HERBERT M. KRITZER, *THE JUSTICE BROKER* 143-55, 159-61 (1990).

²⁰ In one laboratory study, Chertkoff and Conley found that sellers consistently outperformed buyers in a negotiation over a used car and concluded that "the superiority of sellers resulted from the kind of initial offer they made. The initial offer of sellers was significantly more extreme than that of buyers." Chertkoff & Conley, *supra* note 18, at 184. They recommended that "for success in bargaining one ought to open with an extreme opening offer" *Id.* In a similar laboratory study of a used car transaction, Liebert, Smith, Hill, and Keiffer reached a comparable conclusion. The value of the sales contract accepted by uninformed bargainers "was found to be less favorable to themselves when the opponent's first bid was unfavorable to them than when it was favorable." Liebert et al., *supra* note 18, at 438.

²¹ See GIFFORD, *supra* note 16, at 99 (reporting "[e]mpirical research repeatedly demonstrates a significant positive correlation between the amount of the negotiator's original demand and her payoff"); JEFFREY Z. RUBIN & BERT R. BROWN, *THE SOCIAL PSYCHOLOGY OF BARGAINING AND NEGOTIATION* 267, 267 (1975) (surveying the experimental literature and finding "[t]he general conclusion reached in this research is that bargainers attain higher and more satisfactory outcomes when they begin their interaction with extreme rather than more moderate demands").

²² Cooter et al., *supra* note 3, at 231.

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

the risk of alienation and subsequent negotiation breakdown. Such alienation can be caused by either the offeree inferring from the offeror's behavior that no common ground between the parties exists and that negotiation is therefore in vain,²³ or the offeree rejecting settlement because the offeror's negotiating approach has violated his sense of fairness.²⁴

To test this hypothesis, we conducted two sets of laboratory experiments in which we attempted to isolate the impact of moderate and extreme opening offers on the likelihood that a legal dispute will settle out of court. Our results are both counterintuitive and contrary to what the Cooter, Marks, and Mnookin strategic bargaining model would predict. Our data suggests a litigant who begins negotiations with a moderate settlement offer, a softer bargaining strategy, is *less* likely to reach eventual settlement than a litigant who opens with a more extreme position, a harder bargaining strategy. In the following three sections we discuss our research design and experimental results, and suggest that the most plausible explanation of our results is that a litigant who opens a negotiation with a moderate settlement offer inadvertently erects psychological barriers²⁵ — namely, anchoring and adjustment effects and dissonance avoidance — that reduce the likelihood that his adversary will accept a final settlement offer.

²³ GIFFORD, *supra* note 16, at 101 ("An extreme initial offer also risks a walkout or early termination of the negotiation. The other negotiator may decide that the offer is so far out-of-line with what he could agree to that further negotiation would not be profitable.").

²⁴ This effect of hard bargaining is illustrated by results of a series of similar experiments commonly referred to as the "ultimatum game." In this game, one player proposes a division of funds between himself and another party. The other player must then either accept the proposed division or reject it. If he rejects the division, neither party keeps any of the funds — all gains of trade are destroyed. Although the second player's economic interests are better served by accepting any division that provides him with any proceeds at all, in experimental situations the second player frequently rejects divisions that offer him much less than 50% of the proceeds. For a summary of the extensive experimental results, see ROBERT H. MNOOKIN & LEE ROSS, *INTRODUCTION TO BARRIERS TO CONFLICT RESOLUTION* (Arrow et al. eds., forthcoming 1995).

²⁵ For general discussions of psychological barriers to dispute resolution, see Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. (forthcoming 1994). See also Robert H. Mnookin, *Why Negotiations Fail: An Exploration of Barriers to the Resolution of Conflict*, 8 OHIO ST. J. ON DISP. RESOL. 235 (1993); Lee Ross & Constance Stillinger, *Barriers to Conflict Resolution*, 7 NEGOTIATION J. 389 (1991).

II. RESEARCH DESIGN

A. Subjects

Subjects for our experiments consisted of ninety-five Stanford University undergraduate students recruited at a sample of dormitories across campus. Any willing student was asked to complete a written survey form that described a hypothetical litigation scenario and then asked a question about that scenario.²⁶ Participants were told that the survey was part of a Stanford Law School study on how people involved in lawsuits respond to settlement offers. They were told that the surveys would require about ten minutes of their time and that they would be given a popular brand of cookie as compensation for their participation.

B. Basis of Comparison

In each hypothetical litigation scenario, the subjects were asked to assume the role of the plaintiff in the dispute. All the relevant facts of the case were described, as was an analysis provided by their "attorney" of possible outcomes should the subject decide to reject a settlement proposal and instead proceed to trial. At the end of each scenario, the subjects received a final settlement offer that they were instructed they must either accept or reject and proceed to trial. They were then asked to assess the likelihood that they would accept the settlement offer.

There were two versions of each scenario. The only difference between each version was the independent variable — the type of opening offer. Subjects were randomly given either "Version A" or "Version B" of a scenario. Conclusions were drawn as to the effect of the independent variable by comparing the relative attractiveness of the final settlement offer to subjects in "Group A" and "Group B."²⁷

²⁶ Most participants also received one or two other litigation scenarios that tested hypotheses not described in this article.

²⁷ The validity of this type of "between-group" study depends on the essential similarity of the Group A and Group B subjects. E. Allan Lind et al., *Methods for Empirical Evaluations of Innovations in the Justice System*, in EXPERIMENTATION IN THE LAW: REPORT OF THE FEDERAL JUDICIAL CENTER ADVISORY COMMITTEE ON EXPERIMENTATION IN THE LAW (1981), reprinted in JOHN MONAHAN & LAURENS WALKER, SOCIAL SCIENCES IN LAW: CASES AND MATERIALS 60 (1985). Any relevant difference between the members of the two groups creates the possibility that the differences in the results might be caused by differences in the subjects rather than differences in the impact of the independent variables. In our surveys, each group consisted of thirty to sixty-five Stanford University undergraduate students. While there might be relevant differences between individual members of the pool, we assume that

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

because groups of thirty to sixty-five subjects were selected at random from the pool, the law of large numbers will have a leveling effect and no significant differences will exist between the groups on average. See CLIFFORD J. DREW & MICHAEL L. HARDMAN, *DESIGNING AND CONDUCTING BEHAVIORAL RESEARCH* 168-64 (1985) (recommending 20-25 subjects per experimental group); FRED N. KERLINGER, *FOUNDATIONS OF BEHAVIORAL RESEARCH* 119 (3d ed. 1986) (recommending groups of 30 or more).

Although we consider the experimental approach to be the best means of testing the impact of an opening offer on settlement behavior, we recognize that it has its potential pitfalls. In particular, we realize that our design raises concern about external validity; that is, results demonstrated in an experimental setting may not be replicable in the real world of legal disputes. See, e.g., Dan Coates & Steven Penrod, *Social Psychology and the Emergence of Disputes*, 15 LAW & SOC. REV. 655, 667 (1980-81) ("Many available studies have been contrived and [sic] artificial laboratory experiments. It is often difficult to generalize the results obtained under such conditions to more realistic injurious experiences and disputes.").

Our methodology raises three specific external validity concerns. The first is that subjects used in the experiments are not actual litigants, and as a group, they may not be representative of the class of actual litigants. We speculate that the Stanford undergraduates as a whole differ from the class of actual litigants in terms of age, life experience, intelligence, and class. For any of these reasons, Stanford undergraduates may not analyze settlement offers in the same way actual disputants do.

Recently, however, Neale and Northcraft addressed similar external validity concerns in a study where they compared the impact of framing effects on the decision making of amateurs (i.e., students) and experts (i.e., professional negotiators). Margaret A. Neale & Gregory B. Northcraft, *Experts, Amateurs, and Refrigerators: Comparing Expert and Amateur Negotiators in a Novel Task*, 38 ORGANIZATIONAL BEHAV. AND HUM. DECISION PROCESSES 305 (1986). They found that framing had similar effects on both students and professional negotiators. *Id.* at 316. Because they found that framing had a similar impact on the decision making of both groups, they concluded that results from negotiation research relying solely on student subjects can be generalized to the real world of negotiation. *Id.*

Our second external validity concern is that since the lawsuits we examine are hypothetical and crafted to isolate certain variables rather than mirror actual legal disputes, our subjects may not analyze these disputes in the same way they would analyze real world legal disputes. Each lawsuit scenario was designed to be realistic enough to convey to subjects the feeling of an adversarial litigation setting and to make it clear that the stakes of the scenario were similar in scope and magnitude to the stakes of actual lawsuits. However, we described the facts and the legal issues as simply as possible. The scenarios deal with real lawsuit topics (i.e., breach of implied contract, landlord-tenant dispute), but for the sake of simplicity, the legal analyses made available to the participants did not, in all circumstances, correspond to the actual state of the law. In other words, we decided to minimize confusion amongst our subjects so that the experiments would cleanly test the psychological barriers in which we were interested. The cost of this strategy was, at times, simplification of legal doctrine. While we are comfortable that the level of realism in the experiments is sufficient to

C. Controlling the Variables

In developing a theory of how parties negotiate settlements in divorce disputes, Mnookin and Kornhauser identified five factors that influence outcomes: strategic behavior, transaction costs, bargaining endowments created by legal rules, the degree of uncertainty concerning the legal outcome if the parties go to court, and the preferences of the disputants.²⁸ In an effort to isolate and evaluate the impact of the opening offers in our surveys, we attempted to the greatest degree possible to prevent any of these five factors from affecting our results. Our experimental design eliminated the first two factors from consideration. The latter three factors were allowed to affect responses to the scenarios, but their impact on the survey results were neutralized by allowing those factors to influence to the same degree subjects in all experimental groups that were to be compared.

1. Strategic Behavior

The opening offer, when made by the defendant in our hypothetical lawsuit scenarios to the subjects (plaintiffs), represents a strategic bargaining strategy. In our effort to isolate the effect created by that strategy, as reflected in how subjects responded to the offers, we attempted to prevent subjects from responding to the offers with strategic behavior of their own. In other words, we sought to ensure that experimental subjects focused on the substance of the fact patterns presented to them rather than concern themselves with negotiation strategies.

To avoid the possibility of strategic behavior on the part of subjects, they were instructed that the final settlement offers made by the defendants were, in fact, final. Subjects were told that they were required either to

conclude that the experimental results apply to real world situations, we recognize we are not immune to the criticism that more complex legal disputes might have elicited different responses from the subjects.

The final concern is that since the subjects are *playing* the role of litigants and are not actual litigants themselves, they may be less committed to expending the effort to make the best possible decisions about whether to accept an offer based on their preferences. To the extent that careful decision making would make subjects in our experiments either more or less prone to accept the offered settlements, lack of commitment could affect the overall percentage of respondents accepting settlements. Again, however, since we are conducting between-group experiments and have no reason to believe any randomly selected group of subjects from our pool would be, on average, less committed to the experiment than any other, we doubt that this shortcoming would affect our findings in any significant way.

²⁸ Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 966 (1979).

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

accept the offer or to reject it and go to trial. No time would exist for further negotiations or conversations with the defendants before trial,²⁹ and they had no reason to disbelieve that these were the final and best offers the defendant would make. We intended for this description to convince the subjects that they could not hope to achieve a greater distribution of the joint gains of trade that would result from settling the case by considering strategic bargaining tactics of their own.

2. Transaction Costs

In the real world, the high cost of pursuing a claim to trial provides a strong incentive for out-of-court settlement.³⁰ However, to focus the maximum amount of the subjects' attention on the facts of the cases, we eliminated all consideration of legal fees — the most significant transaction cost associated with trials³¹ — from the experimental design. This was accomplished in the simplest way possible: in each scenario, all subjects were told that their attorney would represent them for free, so they need not take legal fees into account when determining whether to accept the final settlement offer.

This contrivance likely caused some percentage of our subjects to reject an offer that they would have accepted in a real-world situation where legal fees were an issue. However, this does not affect the validity of our results. Since our results are based on between-group comparisons rather than the absolute likelihood of subjects accepting their adversary's settlement offer, the fact that all subjects will be relatively more likely to select trial over

²⁹ Dispute resolution scholars have hypothesized that the imposition of a deadline can mitigate psychological barriers to conflict resolution. Because the deadline provides the offeree with a causal explanation for why the offeror is extending the offer, the offeree is less likely to be skeptical of the offeror's motives and more likely to be receptive to the offer. *See, e.g.,* Ross & Stilling, *supra* note 25, at 398–400 (1991). Assuming *arguendo* that deadlines do promote settlement, this would simply make all our subjects slightly more likely to accept settlements than they would be absent the deadline. Because our results are based on between-group comparisons, the impact of the deadline would presumably affect all our subjects equally and not affect the comparative results.

³⁰ *Cf.* Trubek et al., *supra* note 2, at 90–93. Costs fall into two general categories. First, litigants incur out-of-pocket expenses such as attorneys' and expert witness fees. Second, litigants lose the "monetary value of the time" they spend on litigation. Generally speaking, the longer the case remains on the court docket, the higher the costs incurred by the parties. *Id.* at 91.

³¹ *Cf. id.* ("Clients reported the bulk of the expenditures were payments made to lawyers to cover fees and expenses.").

settlement in the experiment than they would be in the real world does not affect the relevant comparisons.³²

3. *Legal Endowments, Uncertainty, and Individual Preferences*

It was critical to the validity of the experimental method that all subjects were endowed with exactly the same legal rights, regardless of which version of a scenario they received. All legally relevant facts were identical across the variations of each scenario, as were the attorneys' analyses of the probability of the plaintiff prevailing at trial, if applicable: all subjects received the same advice from their attorneys about their chances of prevailing at trial regardless of whether or what kind of an opening offer was made by the defendant.

Consistent with the reality that trial results in close cases are difficult to predict, all the scenarios contained uncertainty about whether the plaintiff would prevail at a trial. Uncertainty of outcomes, of course, will encourage relatively risk averse subjects to accept settlement offers. However, given the random distribution of scenario versions throughout the subject pool, we have no reason to believe that Group A subjects would be, on balance, more or less risk averse than Group B subjects in any hypothetical lawsuit situation. As a result, varying degrees of individual risk aversion should have no impact on the experimental results.

Finally, the between-group experimental design also controls for differences in individual preferences. While the value of a settlement offer may vary from one subject to the next based upon relative utility for dollars and relative dislike of the trial process, the random grouping of subjects gives us no reason to believe that, on average, preferences would vary between the experimental groups that we compare.

³² A potential criticism of the no-legal fees approach relates to external validity. *See, e.g., supra* note 27. Since the no-legal fees approach makes an already hypothetical study slightly less realistic, a concern exists that subjects may be less committed to playing the role of a litigant than they would otherwise be, making the applicability of our findings to real world litigation more questionable. We chose to endure these criticisms, however, because we think making the hypothetical fact patterns as simple as possible had immense value in focusing subject attention on the issues we were studying. To present a realistic description of attorney fee structures that subjects should consider when deciding whether or not to accept the settlement offers would have meant complicating the fact patterns with discussions of such issues as hourly rates and contingent fee arrangements.

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

III. EXPERIMENTAL RESULTS

A. Extreme Opening Offers vs. Moderate Opening Offers

In litigation settlement discussions, some defendants open with moderate offers, while others initiate bargaining with more extreme offers.³³ To test our hypothesis that extreme offers would reduce the likelihood of the parties reaching a settlement, we asked two groups of subjects to respond to a hypothetical lawsuit involving a defective new car. All the subjects in both groups were given the following identical set of facts:

Recently, you purchased a brand new BMW 318 automobile from your local dealer for \$24,000. Much to your disappointment, the car has one major problem that you were unable to detect when you test-drove it: it occasionally stalls at stop lights and stop signs and is extremely difficult to start in the morning. While these problems don't make it dangerous to drive, they have cut down on your enjoyment of the car. You have had BMW mechanics look at the car twice, but BMW claims that the car is not defective and there is nothing that can be done to "fix" it. "Some cars just stall more often than others," they told you. You took the car to your own mechanic, and he agreed with the dealer that the problem could not be improved. Due to what you perceive as a defect, you have asked the dealer to take the car back and give you a refund. At this point, you would rather buy a different model of car. The dealer has refused to refund your money.

You have retained an attorney and filed a lawsuit against the dealer seeking a refund of your money. Your lawyer has informed you that the only legal issue is whether or not the car is, in fact, "defective," due to the problems you have recognized. If the case goes to trial, this will be a question for a jury to decide. If a jury decides the car's problems amount to a defect, the dealer will have to take the car back and give you a complete refund of your money. If the jury decides the problems do not amount to a "defect," you will have to keep the car and will not be

³³ In his voluminous empirical study, Kritzer found that 52% of defendants' initial offers were "moderate" or "appropriate" (defined as 75% or more of defendant's view of the stakes in the case), while 32% of defendants' initial offers were "extreme" or "tactical" (defined as 50% or less of defendant's view of the stakes in the case). KRITZER, *supra* note 14, at 122.

entitled to any refund at all. Your lawyer thinks this is a very close case, and could easily go either way.³⁴

Subjects were then told that they had received and rejected an offer by the BMW dealer. Specifically, they were told that the dealer had offered to refund some portion of the purchase price if they would agree to drop the lawsuit and keep the car. As the trial date approached, the dealer asked for another meeting where the subjects were then presented with the following description and question:

At the meeting with you and your lawyer, the BMW dealer offered to settle the case by refunding \$12,000 of the purchase price if you agree to keep the car and drop your lawsuit. The dealer told you that this is his final offer, and given the impracticality of further meetings or discussions prior to trial, you have no reason to doubt that this is the case. Therefore, you must either accept the offer or reject it and proceed to trial. Your lawyer has agreed to represent you for free in this case, so considerations of legal fees should not affect your decision about accepting or rejecting the offer.

Will you:

- | | |
|--|-------|
| Definitely accept the settlement offer | _____ |
| Probably accept the settlement offer | _____ |
| Undecided | _____ |
| Probably reject the settlement offer | _____ |
| Definitely reject the settlement offer | _____ |

In this hypothetical lawsuit, then, all subjects found themselves in an identical legal situation. All faced a choice between a certain cash settlement of \$12,000 (plus continued ownership of the car) and an uncertain trial in which they could receive a \$24,000 refund or nothing at all, depending upon the jury's verdict. The information given to subjects in Group A and subjects in Group B differed in only one respect: subjects in Group A were told that the BMW dealer had made an initial offer, which they had

³⁴ This legal advice accurately reflects the situation under the "lemon laws" of a number of states. In California, for example, the Song-Beverly Act requires sellers of expressly or impliedly warranted goods to either replace them or "reimburse the buyer in an amount equal to the purchase price paid by the buyer" when the seller is unable to service or repair the goods in a reasonable time. CAL. CIV. CODE § 1793.2(d)(1) (West 1993). Disappointed buyers of new cars routinely bring actions under this law. See *Krieger v. Nick Alexander Imports, Inc.*, 285 Cal. Rptr. 717 (1991); *Ibrahim v. Ford Motor Co.*, 263 Cal. Rptr. 64 (1989) (noting that, in legal terms, "defect" is the equivalent of "nonconformity")

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

rejected, of \$2,000. Subjects in Group B were told that the dealer's initial offer, which they had rejected, was \$10,000.³⁵

Although the legal endowments of the subjects in Groups A and B were identical, the opening offer apparently made a difference in the propensity of the subjects to accept the final offer or to reject it and proceed to trial. However, the results ran contrary to our initial hypothesis. Subjects in Group A (who received an extreme opening offer) responded more favorably to the final settlement offer than subjects in Group B. Assigning a numerical value of 1 to 5 for each response, with "definitely accept" scored as a "5" and "definitely reject" scored as a "1," Group A subjects responded with an average score of 3.54, clearly favoring the final offer, while Group B subjects responded with an average score of 2.97, narrowly disfavoring acceptance of the final offer. The difference between the two mean responses is statistically significant.³⁶ More revealing, we believe, is the distribution of responses. Of Group A subjects, 63% (22 of 35) said they would "definitely accept" or "probably accept" the \$12,000 final settlement offer. Only 34% of Group B subjects (12 of 35) indicated that they would "definitely accept" or "probably accept" the offer. The difference between Group A and B acceptors is statistically significant. Contrary to our prediction, the strategic use of an extreme opening offer actually made an eventual settlement more likely than a more equitable opening offer, all other things being equal.

B. To Offer, or Not to Offer?

In comparing the effects of moderate opening offers to the effects of extreme opening offers, we found that subjects were less likely to respond favorably to a final settlement offer preceded by a moderate opening offer than by a more extreme opening offer. What about a moderate opening offer versus no opening offer at all? We conducted a second experiment in an attempt to address this question. We began with the hypothesis that an opening offer relatively consistent with the offeree's sense of legal entitlement would establish a sense of goodwill and make settlement more likely. Our experimental results suggest, however, that a moderate opening

³⁵ The \$10,000 initial offer complies with Professor Gifford's recommendation that a moderate opening offer communicates that the negotiator is "trying to be reasonable" while simultaneously leaving enough of a "cushion" so that the negotiator can make concessions later to avoid appearing intractable. GIFFORD, *supra* note 16, at 109-10.

³⁶ $t(68) = 1.96, p < .05$ (Mann-Whitney, $P < .1$). By social science convention, a "p" value must be no greater than .05 for a difference between populations to be highly statistically significant, meaning the possibility that the difference is due to random error rather than an actual difference in populations is 5%.

offer might actually make eventual settlement less likely than if no early offer is proposed at all.

It is common in settlement discussions for a litigant to open a negotiation with a moderate offer that he "re-offers" at the end of bargaining.³⁷ To test our hypothesis that this would increase rates of settlement, we asked two groups of subjects to respond to a hypothetical lawsuit involving a simple landlord-tenant dispute. All of the subjects in both groups were given a nearly identical set of facts:

Late last summer, you began looking off-campus for an apartment for the upcoming school year. You finally found a satisfactory apartment, but the landlord would agree only to a six-month lease. After careful deliberation, you signed a six-month lease and agreed to pay \$1,000 per month in rent. On September 1, you moved into your new apartment.

Everything was fine for two months. Around Halloween, through no fault of your own, the heater in your apartment broke down. You left a message with the landlord, requesting immediate repair due to the ensuing winter weather. You didn't hear anything from the landlord, so you called him again the next day. The landlord promised to fix your heater, but he never did. A week later, you called him again. Again, he promised to fix it but he never did. Over the next several weeks, you called him a half-dozen times, but he did not return your calls. For four months (Nov, Dec, Jan and Feb), you lived without heat but continued to pay your rent in full. Although you were able to borrow a small space heater from a friend, it failed to keep the apartment from feeling cold and drafty throughout the winter. When your lease expired you moved out and found a new apartment.

After moving out, you told a friend what had happened to you, and she advised you to seek free legal advice through the ASSU.³⁸ You met with an ASSU attorney, who advised you that there was a good chance that you could recover a portion of the \$4,000 rent you paid during those four, cold months. Accordingly, with the attorney's assistance, you filed suit against the landlord in small claims court for failing to heat your apartment. Prior to the small claims court trial, you agreed to meet with the landlord.

³⁷ In his multi-jurisdictional study, Kritzer found that 27% of litigants reported offering the same initial and final settlement offers. KRITZER, *supra* note 14, at 50.

³⁸ "ASSU" is the abbreviation for Stanford University's student government organization, the Associated Students of Stanford University. The ASSU contracts for attorneys to provide legal advice to students at no charge to the student.

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

At the meeting the landlord made you a settlement offer of \$900 if you would agree to drop the lawsuit. He told you that it was the highest offer he would make, and given the impracticality of any further meetings or discussions, there is no reason to doubt him. Therefore, you must either accept the offer or reject it and go to small claims court.

Subjects were then asked to describe their willingness to accept the settlement offer by selecting one of the following five answer choices:

- | | |
|-----------------------------|-----|
| Definitely accept the offer | ___ |
| Probably accept the offer | ___ |
| Undecided | ___ |
| Probably reject the offer | ___ |
| Definitely reject the offer | ___ |

This was the entire amount of information given to Group A subjects. Group B subjects received one additional piece of information: before they consulted with their attorney, the landlord had offered them \$900 if they would agree not to take any legal action, but they had refused to accept this offer at that time.

The opening offer affected settlement rates but, again, contrary to our hypothesis. Although the legal endowments of the subjects in Groups A and B were identical, subjects in Group B, who had previously rejected a moderate \$900 opening offer, were much less likely to accept this offer when made immediately prior to a court date than were subjects in Group A, who had not received a previous offer.

Fifty-seven percent (34 of 60) of subjects in Group A indicated that they would "definitely reject" or "probably reject" the final settlement offer. While a majority refused the offer, the fact that forty-three percent of respondents said they would definitely or probably accept the offer or were undecided indicates that the offer did not appear to be extreme or one-sided.³⁹ A substantially higher percentage of Group B subjects responded unfavorably to the landlord's final settlement offer, after receiving the same offer early in the negotiations. Seventy-four percent of these subjects indicated that they would definitely reject or probably reject the landlord's offer. The difference between Group A and B rejecters, those who responded that they would probably or definitely reject the landlord's final

³⁹ Seven respondents would definitely accept, fourteen would probably accept, and five were undecided.

offer, is statistically significant.⁴⁰ For the defendant landlord in our hypothetical scenario, making a relatively equitable offer early in the settlement process actually reduced the likelihood that a final settlement would be reached when he simply repeated that offer prior to attending small claims court.

IV. DISCUSSION

In both experiments, the subjects' responses to final settlement offers were influenced systematically by the initial offers they received (or did not receive). Plaintiffs were less likely to accept a final settlement offer when it was preceded by a reasonable opening offer than when it was preceded by an extreme offer, or no offer at all.

Rational actor models of settlement behavior cannot persuasively explain these results. The Cooter, Marks, and Mnookin strategic bargaining model, which hypothesizes that negotiations might fail due to disputes about how to divide the gains of trade, suggests contrary results: an extreme opening offer might alienate the opposing party, thus creating a more competitive relationship which could impede agreement. A moderate opening offer, in contrast, could be expected to have the opposite effect, establishing a cooperative atmosphere which would make settlement more likely.⁴¹

⁴⁰ The mean response of Group A subjects was 2.60, while the mean response of Group B subjects was 2.16, but the difference between the means does not rise to the level of statistical significance.

⁴¹ A major distinction in negotiation theory is between cooperative negotiation styles and competitive negotiation styles. See, e.g., Ronald J. Gilson & Robert H. Mnookin, *Disputing Through Agents: Cooperation and Conflict Between Lawyers in Litigation*, 94 COLUM. L. REV. 509 (1994) (suggesting litigation presents a prisoner's dilemma situation in which litigants are often forced to choose a competitive posture rather than a cooperative one); Robert J. Condlin, *Bargaining in the Dark: The Normative Incoherence of Lawyer Dispute Bargaining Role*, 51 MD. L. REV. 1, 11 (1992) ("If dispute settlement is primarily strategic, its central strategic choice is whether to cooperate or compete, both in deciding how to make each of the hundreds of individual tactical maneuvers and moves that make up a single negotiation, and in selecting an overall bargaining strategy."). While scholars disagree about which type of strategy is more likely to produce favorable results for a negotiator, cooperative strategies are generally believed to improve the likelihood that a settlement will be reached. See, e.g., ROGER FISHER ET AL., *GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN* 56-80 (2d ed., 1991); Gilson & Mnookin, *supra* at 513 ("At the core of our story is the potential for disputing parties to avoid the prisoner's dilemma inherent in much litigation by selecting cooperative lawyers. . . .").

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

The traditional economic model of litigation settlement also fails to explain our results. According to this model,⁴² a rational plaintiff should determine whether a settlement offer or trial has a higher risk-adjusted present value and select accordingly. The fact that a defendant *previously* made a moderate opening offer, rather than an extreme opening offer or no offer at all, should not systematically influence plaintiffs' responses to the final settlement offer like it did in our experiments.⁴³

An opening offer could rationally affect a litigant's evaluation of a final settlement outcome if it communicates information known by the offeror but unknown to the offeree that alters either the offeree's estimation of his chances of prevailing at trial or the amount he would most likely win (or lose) at trial.⁴⁴ Our experiments were designed to attempt to eliminate this type of signaling effect. Subjects who received an extreme opening offer or no opening offer at all received the same estimate of likely success at trial from their attorney as did subjects who received moderate opening offers, so the subjects' attorney's assessment of the case's merits should not have differentially affected Group A and Group B subjects. If subjects feared the defendant may have had a more accurate assessment of trial probabilities than their own attorney, they might have looked to the defendant's *final offer* for evidence of the defendant's analysis of the legal merits of the case. However, because the final offer made to Group A and Group B subjects was the same in each scenario, the adversary's evaluation of trial probabilities should not have differentially affected Group A and Group B subjects either. While it is possible that some subjects might have inferred from a low initial offer or no initial offer that Group A defendants were more confident about their chances in court than Group B defendants (who made moderate opening offers), even in light of identical final offers, we believe it is highly improbable that the observable difference between Group A and B subjects was caused by subjects inferring such an oblique, indirect, and misguided signaling effect from the defendants' opening offers.⁴⁵

⁴² See Priest & Klein, *supra* note 1; Landes, *supra* note 1; Posner, *supra* note 1, at 417-20.

⁴³ See GIFFORD, *supra* note 16, at 100 ("If the other negotiator reasonably determines his minimum disposition, target, and initial offer, his counterpart's initial demand should have no effect.").

⁴⁴ See *id.* at 119-39.

⁴⁵ As long as a final offer cannot be raised before trial, that final offer should be based on all the relevant evidence and experience the offeror possesses at the time the offer is made. If a wide gap exists between the final offer and earlier offers, that might suggest the offeror was attempting to bluff, or that he received new information between the time he made the opening offer and the final offer. It might also suggest the offeror has staying power to endure

Because we are unable to explain satisfactorily the results of our experiments with rational actor behavioral theories, we turn to cognitive and social psychology for insights. We suggest that our findings provide empirical support for the proposition that litigants, when making reasonable opening offers to their adversaries, inadvertently erect psychological barriers that impede settlement.

A. Anchoring and Adjustment

Research by cognitive psychologists demonstrates that people make estimates by starting at an initial anchor from which they adjust to yield a final estimate.⁴⁶ Different anchors create different expectations and yield estimates that tend to be biased toward the original anchor.⁴⁷ Thus, anchors impede rational decision making on the part of people exposed to them by unduly influencing their judgment.⁴⁸

In one anchoring study, for instance, Joyce and Biddle divided professional auditors into two groups. The two groups were anchored as follows: The members of Group A were asked to indicate whether they thought executive-level management fraud occurred in more than 10 out of every 1,000 companies audited by what where then the Big Eight accounting firms. The members of Group B were asked to indicate whether they thought executive-level management fraud occurred in more than 200 out of every 1,000 companies audited by Big Eight accounting firms. The experimenters tested whether these anchors — “10” for Group A subjects and “200” for Group B subjects — would influence the answer to the second question they asked the members of both groups: “What is your estimate of the number of Big Eight clients per 1,000 that have significant executive-level management fraud?” Consistent with anchoring and adjustment theory, Group A and B responses varied systematically. Group A subjects estimated an average of 16.52 incidents of fraud per 1,000, while Group B subjects estimated an average of 43.11 incidents of fraud per 1,000.⁴⁹ Thus, the rational judgment of these professional auditors was influenced by the initial anchors to which they were exposed and by their inability to adjust sufficiently from them.

a drawn-out negotiation process. But as long as the final offers are identical, the size of the gap does not communicate information about the strength of the offeror's legal position.

⁴⁶ Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124, 1128-30 (1974).

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ Edward J. Joyce & Gary C. Biddle, *Anchoring and Adjustment in Probabilistic Inference in Auditing*, 19 J. ACCT. RES. 123 (Spring 1981).

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

In a similar study, Bazerman and Neale examined the impact of anchoring on real estate agents. They gave four groups of agents different list prices for a piece of residential real estate and asked the agents to estimate the appraised value of the house, an appropriate listing price, a reasonable price to pay for the house, and the lowest offer they would accept for the house if they were the seller. The researchers found that the list prices served to anchor the agents and affect their estimates. In their words, "[t]he listing price had a major impact on their valuation process; they were more likely to have high estimates on all four prices when the listing price was high than when it was low."⁵⁰ Bazerman and Neale concluded that "the anchoring effect is not only present, it is pronounced."⁵¹

Dispute resolution scholars have hypothesized that anchoring effects may impede rational decision making in the negotiation context, particularly with respect to opening offers. That is, opening offers may anchor the opposing side's expectations in negotiation and impede rational negotiating behavior.⁵² Our results support this hypothesis. In our first experiment, we exposed subjects to different opening offers, and these opening offers affected the subjects' reactions to the final settlement offer, even though no difference in legal entitlements existed. We believe that the opening offers anchored subjects' expectations. Subjects in Group A, who received the extreme initial offer of \$2,000, expected to settle for a relatively small amount, so the final offer of \$12,000 appeared generous. Subjects in Group B, who received a moderate initial offer of \$10,000, expected to settle for a relatively large sum, so the final offer of \$12,000 did not appear as favorable by comparison. The moderate opening offer apparently anchored subjects' expectations in a way that tended to discourage settlement.

⁵⁰ MAX H. BAZERMAN & MARGARET A. NEALE, *NEGOTIATING RATIONALLY* 27 (1991).

⁵¹ *Id.* at 28.

⁵² *See, e.g., id.* at 25 ("an anchor will inhibit individuals from negotiating rationally"); MARGARET A. NEALE & MAX H. BAZERMAN, *COGNITION AND RATIONALITY IN NEGOTIATION* 49 (1991) ("Susceptibility to this bias can influence the negotiation process in a number of ways"); Daniel Kahneman, *Reference Points, Anchors, Norms, and Mixed Feelings*, 51 *ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSING* 296, 309 (1992) ("The implications of anchoring effects for negotiations have often been noted.").

B. Dissonance Avoidance

Cognitive dissonance theory sheds light on our second set of results. Cognitive dissonance is a negative drive state that arises when a person simultaneously holds two cognitions that are psychologically inconsistent.⁵³ For example, when a person knows that smoking is likely to cause lung cancer but continues to smoke, he may experience dissonance.⁵⁴ Because dissonance is a negative drive state, people are generally motivated to avoid it when they see that it might occur.⁵⁵

Negotiation scholars have suggested that dissonance avoidance may serve to prevent a negotiator from accepting terms that he has previously rejected. Ross and Stillinger argue that, "[w]hen the status quo has been maintained for long periods of time, and opportunities for resolution offering apparent advantages over the status quo have been rejected in the past, the problem of 'cognitive dissonance' becomes apparent."⁵⁶ Similarly, Mnookin argues that, "[r]ather than embracing today what could have been achieved yesterday without any additional financial, economic, human, or political costs, it is enormously tempting to 'stay the course' and to convince oneself, and anyone else who can be persuaded, that more advantageous terms (terms that could truly justify one's past expenditures and sacrifices) can be won in the future."⁵⁷

Our results provide empirical evidence to support the dissonance avoidance hypothesis, as it applies in the litigation context. In our second experiment, more Group A subjects (who had not received a previous offer) than Group B subjects (who had received a previous \$900 offer) expressed a willingness to accept a final \$900 settlement offer. To be precise, 35% of the subjects in Group A said they would definitely or probably accept this final settlement offer. We therefore hypothesize that 35% of the subjects in Group B (who received an opening offer of \$900) made some sort of an effort to avoid the dissonance that would be created by accepting each of these propositions: (1) A \$900 settlement is more attractive to me than an uncertain trial verdict, and (2) I previously rejected a \$900 offer. Because only 23% of the subjects in Group B said that they would probably or definitely accept the settlement offer, we infer that approximately one-third of those confronting cognitive dissonance did so by deciding that a \$900

⁵³ Elliot Aronson, *The Theory of Cognitive Dissonance: A Current Perspective*, in *ADVANCES IN EXPERIMENTAL PSYCHOLOGY*, VOL. 41 (Leonard Berkowitz ed., 1969). See also LEON FESTINGER, *A THEORY OF COGNITIVE DISSONANCE* 1-9 (1957).

⁵⁴ *Id.* at 2.

⁵⁵ *Id.* at 3.

⁵⁶ See Ross & Stillinger, *supra* note 25, at 395-96.

⁵⁷ MNOOKIN & ROSS, *supra* note 24, at 31.

OPENING OFFERS AND OUT-OF-COURT SETTLEMENT

settlement was not, in fact, preferable to trial. The other two-thirds reacted to the internal conflict in some other way, perhaps rationalizing that while \$900 was a favorable settlement, it was also appropriate for them to reject the offer initially — either because they had not yet consulted an attorney or because they had hoped to hold out for a more favorable settlement which failed to materialize. In our opinion, the reconciliation processes employed by the latter two-thirds was more rational than the processes employed by the former one-third. However, our results indicate that if an early settlement offer later helps to create a need for dissonance avoidance in the mind of the plaintiff, that plaintiff is likely to respond by rejecting final settlement offers that otherwise might be acceptable. These results also support the more general conclusion of our research: a party who opens negotiations with a moderate offer is less likely to reach a negotiated settlement than one who does not.

V. CONCLUSION

Our experimental results on the effects of opening offers in litigation settlement negotiations have implications for both legal practitioners and students of negotiation. For practitioners, our results suggest that the value of positional bargaining — a black sheep in the practical negotiation literature⁵⁸ — may be worth reconsidering. While it has been suggested that staking out a position and using it as a reference point in negotiations rather than bargaining on the basis of underlying interests can increase the risk of negotiation breakdown,⁵⁹ our findings suggest that the opposite could be true in some situations: establishing a position can anchor the adversary's aspiration level and therefore, increase the range of outcomes acceptable to both parties. On a more general level, our findings caution that cooperative negotiation behavior for the purpose of creating an atmosphere of goodwill may, in some situations, make eventual settlement less, rather than more, likely.

For dispute resolution scholars, our findings provide one piece of empirical support for the criticism that standard economic and strategic

⁵⁸ See generally FISHER ET AL., *supra* note 41, at 10 (counseling negotiators to "focus on interests, not positions"). At least one author has referred to GETTING TO YES as "the most referenced piece of writing on negotiation." Max Bazerman, *Getting Beyond Yes; Where Negotiation is Now and Where it Should Go*, DISP. RES. FORUM, May 1987, at 3, 7.

⁵⁹ See *id.* at 6-7. In addition to suggesting positional bargaining is strategically undesirable, Fisher, Ury & Patton also argue that focusing on positions rather than underlying interests may lead to objectively less "fair" outcomes, may damage long-term relationships and may cause bargaining to require more time and resources than it might otherwise. *Id.* at 13-14.

bargaining models of settlement are incomplete because they fail to account for psychological processes that deviate from assumptions of profit maximizing behavior. If future research confirms our suggestion that anchoring and dissonance avoidance can cause a reduction in the likelihood of settlement, critical reexamination of these models' utility is appropriate.